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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

RAYMOND L. DIRKS,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

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BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE*

Pursuant to Rule 36.2 of this Court, and with the consent of the parties, the Securities Industry Association submits this brief as *amicus curiae*. It supports neither party.*

QUESTION ADDRESSED

Whether the Honorable J. Skelly Wright erred in concluding that the federal securities laws taken as a whole impose upon broker-dealers, by virtue of their status as such, a broad legal disclosure obligation in favor of the public at large and a correlative duty to report to the Commission supposed federal securities law violations committed by others.

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* Since the Securities Industry Association supports neither party, this brief is being submitted to the Court within the time prescribed for the petitioner, as required by Rule 36.2.

THE INTEREST OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association (the "Association") is a trade association comprised of approximately 500 brokers and dealers in securities who transact business throughout the United States and the free world. Its membership is responsible for over 90 percent of the securities brokerage business conducted in this country and includes members of every national securities exchange as well as securities firms that are not members of any exchanges.

The Association's members service securities investors of every size and type and perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the Association is generally recognized as a spokesman for the securities industry in general and the broker-dealer community in particular.

The Association recognizes that high standards of ethical behavior are required of brokers and dealers in securities. In the court below, however, the Honorable J. Skelly Wright, Circuit Judge, in a published opinion expressing his views alone, has presented these ethical responsibilities as the basis of a vague but expansive "duty" of brokers and dealers to the public and to the Securities and Exchange Commission, a violation of which Judge Wright found to contravene the antifraud provisions of the federal securities laws.

This formulation—converting standards of business ethics into a predicate for civil and presumably criminal responsibility—has no basis in law or in sound public policy. If accepted and followed, however, it could work substantial mischief, calling into question the lawfulness of a wide variety of necessary functions performed by brokers and dealers and their employees. For these reasons, the Association submits this memorandum, *amicus curiae*. It urges this Court expressly to reject Judge Wright's concept of a general duty and the erroneous theory upon which it is based. It takes no position concerning any other matter in issue.

STATEMENT OF THE CASE

1. Petitioner, Raymond L. Dirks, was an officer of a registered broker-dealer. He specialized in providing investment advice about the insurance industry, primarily to institutional investors. Mr. Dirks was not directly compensated for his advisory services, but benefited when those whom he advised directed their brokerage business to the firm by which he was employed.

In March 1973, Mr. Dirks received information from a former employee of Equity Funding Corporation of America, the securities of which were traded on the New York Stock Exchange, to the effect that the assets of that Company were vastly overstated as the result of fraudulent internal corporate practices. As a result, Mr. Dirks examined and analyzed publicly available data, sought confirmation of what he had been told from others in the investment community and solicited information from then present and past officers and other employees of the Company.

While Mr. Dirks was investigating the matter, he had been in contact with a number of investors and analysts with whom he had candidly discussed the progress of his investigation and the information he had obtained. Some of those to whom he spoke sold their Equity Funding securities.

2. On the basis of these facts, the Securities and Exchange Commission censured Mr. Dirks. *In re Dirks*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶82,812 (hereinafter the "SEC Opinion"). It found that he had aided and abetted several investment managers in violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a), and Rule 10b-5, 17 CFR §240.10b-5, promulgated by the Commission pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C §78j(b). The Commission found that the investment managers had sold Equity Funding securities on the basis of material, non-public, "inside" information that Mr. Dirks had supplied. The Commission held, SEC Opinion, *supra*, at 83,945:

> "The dissemination of inside information to those who utilize it in dealing with uninformed public investors

constitutes an act, practice, or course of conduct which operates as a fraud on investors. Even where the tipper does not himself engage in trading, he aids and abets the violation by providing the means by which the wrongful act occurs."

The Commission expressly recognized the important function served by securities analysts who "seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients." It observed that "market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." It concluded, however, that "professionals have no special license to ignore the insider trading proscriptions of the federal securities laws." Thus, "regardless of their motivation or occupation," persons who "come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' . . . must either publicly disclose that information or refrain from trading." SEC Opinion, *supra*, at 83,945 (footnotes omitted).

3. Upon petition for review, the United States Court of Appeals for the District of Columbia Circuit affirmed the Commission's decision without opinion, *Dirks* v. *SEC*, 675 F.2d 1339 (D.C. Cir. 1982). In a judgment entered March 29, 1982, the Court stated, Judge Tamm dissenting, that "[t]he record in this case fully supports the Commission's finding that petitioner breached his duty to the Commission and to the public not to misuse insider information . . . ," *see Dirks* v. *SEC*, 681 F.2d at 824, n. (D.C. Cir. 1982).

4. The matter was not, however, left in that posture —focused sharply upon the misuse of insider information. Instead, in a widely publicized opinion, 681 F.2d 824, the Honorable J. Skelly Wright, Circuit Judge, expressed his views concerning what he perceived to be a far broader responsibility to the public and to the Commission arising solely out of Mr. Dirks' employment by a broker-dealer, *id.* at 840-842.

Judge Wright, *id.* at 835-837, acknowledged the importance to this case of this Court's opinion in *Chiarella* v. *United States*, 445 U.S. 222 (1980). There, this Court recognized that a failure to disclose material information in connection with the purchase or sale of securities might operate as a fraud or deceit under Rule 10b-5—but only where there exists an identifiable duty to disclose.

This Court also explicitly rejected the existence of any "general duty between all participants in market transactions to forgo actions based on material, nonpublic information." It observed that "[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent." And it noted that "no such evidence emerges from the language or legislative history of §10(b)." *Id.* at 233.

Nevertheless, Judge Wright concluded that Mr. Dirks "had obligations to the SEC and to the public completely independent of any obligations" arising out of the misuse of material inside information obtained from sources at Equity Funding. These broader obligations were said to be "implicit in the scheme of broker-dealer registration under the Federal Securities laws," and to give rise to a "duty to disclose-or-refrain" even in circumstances in which no similar duty would be imposed upon the insiders at Equity Funding from whom Mr. Dirks obtained the information. 681 F.2d at 840. Indeed, according to Judge Wright, "a duty to report what he had learned to the SEC and not to foster such sales" is a "fundamental obligation [that] would inhere in the securities laws enacted by Congress even if they included no generally applicable antifraud provisions," *id.* at 841-842.

Thus, without regard to whether inside information was involved, whether information was obtained by misappropriation, conversion or other unlawful means, or whether

other market participants might similarly have gained access to relevant information, and without regard to Congressional inclusion of generally applicable antifraud provisions in the federal securities laws, Judge Wright concluded that broker-dealers, and those who obtain information from them, are forbidden to trade in securities without first disclosing any material, non-public information they possess.

SUMMARY OF ARGUMENT

Unless the principle formulated by Judge Wright is emphatically rejected by this Court and the uncertainty engendered by his opinion is thus laid to rest, the adverse effects upon this nation's capital markets could well be substantial. Brokers will be severely inhibited in their advisory and investment banking activities and dealers will be placed in needless jeopardy when they perform specialist, block positioning, floor trading and other functions essential to the efficient operations of the securities markets. Judge Wright apparently did not consider these consequences.

To impose upon broker-dealers a broad duty to disclose all material, non-public, non-inside information they obtain in the normal course of their business or to refrain from trading (or recommending trades) in affected securities would abrogate the detailed and sophisticated legislative scheme enacted by Congress, and implemented through rules adopted by the Commission, expressly to deal with broker-dealer responsibilities. Similarly, to charge broker-dealers with the duty to police the securities law violations of others and to "report [such violations] ... to the SEC" would assign obligations to broker-dealers that are instead vested by express statutory provisions in the self-regulatory organizations and in the Commission itself.

ARGUMENT

THERE IS NO BASIS IN LAW OR IN SOUND PUBLIC POLICY FOR IMPOSING UPON BROKER-DEALERS THE BROAD DUTIES FORMULATED BY JUDGE WRIGHT

A. *Judge Wright's formulation does substantial violence to the statutory scheme he claims to vindicate.*

Judge Wright's conclusion that there are "obligations, implicit in the scheme of broker-dealer registration under the federal securities laws, [which] provide a basis for imposing a duty to disclose-or-refrain on Dirks even if we would not impose it on his sources at Equity Funding," 681 F.2d at 840, contravenes the careful pattern of detailed regulation of broker-dealers embodied in the federal securities laws and finds no support in the decided cases.

Judge Wright correctly recognizes that "the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly." He asserts, however, that "fairness to their customers is not the only obligation that the securities laws impose on broker-dealers," and observes that brokers and dealers are subject to "myriad duties not imposed on corporate officers or other members of the general public," 681 F.2d at 840.[1]

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[1] The duties imposed upon issuers and their insiders, while different from those imposed upon brokers and dealers, are no less significant. In addition to the substantial responsibilities and potential liabilities that arise in connection with public offerings and otherwise under the Securities Act, the Securities Exchange Act imposes registration and disclosure obligations upon issuers of exchange-traded and over-the-counter securities, periodic reporting requirements, and broad disclosure obligations with respect to proxy solicitations.

In order specifically to inhibit misuse of material corporate information by insiders, it also requires that officers, directors and substantial shareholders of a company report their securities transactions and that short-term profits arising out of such transactions shall inure to and be recoverable by the company. No comparable obligation is imposed upon brokers and dealers.

In view of the primary disclosure requirements imposed upon issuers and their insiders, it seems anomalous for Judge Wright to have required disclosure from outside professionals while stating, 681 F.2d at 840, that he might not subject the corporate insiders (from whom the information was obtained) to the same duty.

This is surely true. Numerous provisions of the Securities Exchange Act of 1934, both as originally adopted and as amended several times since, establish a system for the comprehensive regulation of the securities markets and the activities of brokers and dealers.[2] But, contrary to what Judge Wright has assumed, the "myriad duties" that the Act expressly imposes are themselves the clearest evidence that Congress did not choose to define the disclosure obligations of broker-dealers without regard to the special functions they perform, or to impose upon them a standard so vague and uncertain of application that its very existence would remain undiscovered for nearly 50 years.

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[2] *E.g.*, Securities Exchange Act §5, 15 U.S.C. §78e (prohibiting broker-dealers from effecting transactions on unregistered exchanges); §§6(c)-(f), 15 U.S.C. §§78f(c)-(f) (prescribing conditions and limitations of broker-dealer membership on exchanges, discipline of such members, commissions chargeable, and compliance by non-members with exchange rules); §7(c), 15 U.S.C. §78g(c) (regulating extension of credit by broker-dealers); §8, 15 U.S.C. §78h (restricting borrowing and lending by broker-dealers); §§9-10, 15 U.S.C. §§78i-j (prohibiting manipulation of security prices and other manipulative and deceptive acts); §11, 15 U.S.C. §78k (restricting trading by broker-dealers); §11A(c), 15 U.S.C. §78k-1(c) (regulating broker-dealers' transactions in certain securities); §12(a), 15 U.S.C. §78*l*(a) (prohibiting broker-dealers from effecting transactions in unregistered non-exempt securities); §14, 15 U.S.C. §78n (regulating broker-dealers' activities in connection with proxy solicitations and tender offers); §15(a)-(d), 15 U.S.C. §78*o* (a)-(d) (requiring registration of broker-dealers and prohibiting broker-dealers from manipulative and deceptive acts in off-exchange transactions); §16(d), 15 U.S.C. §78p(d) (exempting certain market making activities from profit recapture); §17, 15 U.S.C. §78q (prescribing recordkeeping and reporting requirements for broker-dealers); §17A(e), 15 U.S.C. §78q-1(e) (relating to movement of securities certificates among broker-dealers); §18, 15 U.S.C. §78r (prescribing liability for misleading statements in reports filed under the Act); and §§19(d)-(g), 15 U.S.C. §§78s(d)-(g) (relating to disciplinary proceedings by self-regulatory organizations and their enforcement of broker-dealers' compliance with the Act); implemented by the rules promulgated by the Commission thereunder. Provisions of the Securities Act of 1933, 15 U.S.C. §77a, *et seq.*; the Investment Advisers Act of 1940, 15 U.S.C. §80b-1, *et seq.*; and the Investment Company Act of 1940, §80a-1, *et seq.*; also regulate the activities of broker-dealers acting in various capacities.

Thus, in *Chiarella* v. *United States*, 445 U.S. 222, 233 n.16 (1980), with specific reference to the role of broker-dealers in the securities markets, this Court recognized that

> "the problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets."

It found that the "detailed and sophisticated regulation" prescribed by Congress to deal with "the problems caused by misuse of market information" provided a strong reason to *reject* the existence of any general duty to the marketplace, and that "Congress's careful action" in this respect "contrasts, and is in some tension, with the broad rule of liability . . ." (which this Court characterized as "a new and different theory of liability") that it had been asked to adopt, 445 U.S. at 233-234.

Furthermore, this Court emphasized that

> "the 1934 Act cannot be read '"more broadly than its language and the statutory scheme reasonably permit."' . . . Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of §10(b) . . . ."

445 U.S. at 234-235 (citations omitted).[3] Justice Powell, on behalf of the majority, recognized that §10(b) imposes a duty

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[3] In *Chiarella*, as the foregoing quotations evidence, this Court addressed a case of non-disclosure of so-called market information, but the premises of that decision addressed problems of non-disclosure generally:

> "[A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b) despite the absence of statutory language or legislative history specifically addressing the legality of non-disclosure."

445 U.S. at 230.

to speak arising "from a relationship of trust and confidence between parties to a transaction," *id.* Active participation by an employee in transactions operating as a fraud on a broker-dealer's customer has been held to be a breach of a duty arising from a relationship of trust and confidence.[4] Other members of this Court expressed their views that a duty to speak might arise out of use of information improperly obtained, wrongfully converted or otherwise derived by unlawful means. Utilization for an employee's own benefit of information obtained from a broker-dealer's investment banking client has been held to be a breach of a duty arising out of deceitful misappropriation.[5]

Additional, similar duties on the part of broker-dealers, in favor of customers and co-professionals (among others), arise under several of the provisions cited in footnote 2, *supra*. But, in contrast to the duty Judge Wright gleans from the "scheme of federal securities regulation, taken as a whole," 681 F.2d at 840, a breach of those duties is in each case a violation of a particular statutory provision or of a particular rule adopted by the Commission, and in each case those duties run in favor of identifiable persons or discrete groups—not in favor of the public at large.

Section 10(b) was not enacted to allow the Commission by regulation to abrogate the specific provisions of the Act. Rather, it was intended (as if to avoid the need for construing obligations out of the general statutory scheme) to allow the Commission to fill in the statutory interstices by providing, in effect, "Thou shalt not devise any other cunning devices."[6] Judge Wright's interpretation would override both the pervasive detailed structure of broker-dealer regulation and the broad interstitial thrust of §10(b).[7]

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[4] *Rolf* v. *Blyth, Eastman Dillon & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,525, *amending opinion reported at* 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

[5] *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981).

[6] Stock Exchange Regulation: Hearings before House Comm. on Int. and For. Commerce, 73d Cong., 2d Sess. 115 (1934).

[7] Nor do the provisions of the Securities Act provide any support for Judge Wright's conclusions. That Act was adopted to regulate "flotation" of securities through a requirement of registration of securities and the imposition of liability for improper disclosure in the registration statement upon the issuer and its directors, accountants, engineers, appraisers and underwriters, among others. "This throws upon *originators* of securities a duty of competence as well as

In support of the duty he has articulated, Judge Wright relies primarily upon broad generalizations concerning "the importance of broker-dealers within the securities markets," *id.* at 840, the obligation of broker-dealers "to meet a high standard of ethical behavior in their activities," *id.*, and the Congressional objective "to achieve a high standard of business ethics . . . in every facet of the securities industry," *id.*, citing *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979) (emphasis omitted). Thus, in substance, he invokes the "remedial purposes" of the securities laws. *But see Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 578 (1979); *SEC* v. *Sloan*, 436 U.S. 103, 115-116 (1978).

Judge Wright is correct, of course, that the draftsmen of the federal securities laws were sensitive to the ethical responsibilities of brokers and dealers. But it does not follow, as he suggests, that they wrote those ethical responsibilities into positive law.

To the contrary, Congress has left the responsibility for the development and enforcement of ethical standards with the securities industry itself. The Securities Exchange Act draws a deliberate distinction between express legal obligations of brokers and dealers, which are primarily the responsibility of

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innocence which the history of recent spectacular failures overwhelmingly justifies." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933) (emphasis added). Broker-dealers acting as underwriters have been held by the Commission to assume a broad duty in connection with origination of securities of certain issuers previously unknown to the public securities markets; broker-dealers acting as distributing dealers or dealers active in the market during a prescribed period after commencement of a distribution are subject to prospectus delivery requirements and standards of accuracy and completeness in the affirmative disclosures they make to purchasers.

But, except to the extent that a broker-dealer may have a role in the public offering of specific securities, and then only while that role continues, the Securities Act imposes no greater disclosure obligation upon a broker-dealer than upon any other market participant. Thus the Act specifically exempts, from registration and disclosure document delivery requirements, "the execution by brokers of customer orders in open market," H.R. Rep. No. 85, *supra*, at 6. It further recognizes "that a dealer is often concerned not only with the distribution of securities but also with trading in securities," *id.* at 16. Consequently, it also exempts "transactions by a dealer in securities not connected by time or circumstance with distribution of a new offering," *id.* at 6. *See* Securities Act §§4(3) and 4(4), 15 U.S.C. §§77d(3) and d(4).

the Commission to enforce,[8] and their ethical responsibilities, which are the province of the self-regulatory organizations.[9]

Thus, this Court has repeatedly noted that

> "[t]wo types of regulation are reflected in the [Securities Exchange] Act. Some provisions impose direct requirements and prohibitions. Among these are mandatory exchange registration, restrictions on broker and dealer borrowing, and the prohibition of manipulative or deceptive practices. Other provisions are flexible and rely on the technique of self-regulation to achieve their objectives."[10]

Accordingly, as the relevant committees of both houses of Congress have recognized, under the Securities Exchange Act

> "[t]he SEC has the authority and responsibility to assure compliance by all broker-dealers with the *legal* requirements of the Exchange Act and of the rules which the SEC is authorized to promulgate under the Exchange Act,"

while, at the same time,

> "[i]ndustry organizations, *i.e.*, the exchanges and the NASD, are delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with *both legal requirements* laid down in the Exchange Act *and ethical standards going beyond those [legal] requirements.*"

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[8] *See* Securities Exchange Act, §15(b)(4), 15 U.S.C. §78*o*(b)(4) (authorizing administrative enforcement proceedings against brokers and dealers) and §§21(d) and (e), 15 U.S.C. §§78u(d) and (e) (authorizing the Commission to institute civil actions in district court to enjoin violations of the Act or rules and regulations thereunder or to compel compliance with their requirements).

[9] The National Association of Securities Dealers, Inc., for example, is required by Section 15A(b)(6) of the Act, 15 U.S.C. §78*o*-3(b)(6), to have rules designed not only "to prevent fraudulent and manipulative acts and practices," but also "to promote just and equitable principles of trade . . . ." An identical obligation is imposed by §6(b)(5), 15 U.S.C. §78f(b)(5), upon securities exchanges registered with the Commission. This and the related requirement of §6(d), 15 U.S.C. §78f(d), "that an exchange's rules be 'just and adequate to insure fair dealing and to protect investors,' has obvious relevance to the area of rules regulating the conduct of an exchange's members." *Silver* v. *NYSE*, 373 U.S. 341, 353 (1963).

[10] *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117, 127 (1973); *Gordon* v. *NYSE*, 422 U.S. 659, 667 (1975). *See Silver* v. *NYSE, supra*, 373 U.S. at 352.

This "fundamental pattern established in 1934 has not been essentially changed since then . . . ."[11]

The Commission has also formally reported to the Congress upon both "[t]he legal restraints and [the] ethical standards surrounding the securities industry."[12] These obligations, it observed, are not defined entirely as a matter of law, but are reflected as well "in the rules, regulations and practices of the national securities exchanges and the National Association of Securities Dealers, Inc." And it specifically noted—as Judge Wright did not—that there are "significant distinctions between actual legal obligations and ethical ideals." 1 Special Study at 237-238.

In view of the foregoing, it is not surprising that no prior judicial interpretation of any of the statutory provisions relating to brokers and dealers has gone so far as even to hint at a duty so broad as the one Judge Wright has articulated. Some of those decisions upon which Judge Wright relies relate to obligations indisputably owed by broker-dealers—but owed to their customers alone, not to the public or to the Commission; the remaining decisions he cites concern issues not involving the obligations of brokers or dealers at all.[13]

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[11] *See* S. Rep. No. 94-75, 94th Cong., 1st Sess. 22-23 (1975) (emphasis added); S. Rep. No. 93-865, 93d Cong., 2d Sess. 19 (1974) (emphasis added). *Accord* H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 48 (1975); H.R. Rep. No. 93-1476, 93d Cong., 2d Sess. 45 (1974).

[12] Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) (hereinafter "Special Study"). *See generally*, 1 Special Study at 237-240 (Legal and ethical obligation of the industry to the public), 302-308 (Federal controls over selling practices), 308-314 (NASD controls over selling practices), 314-321 (NYSE controls over selling practices), and 321-322 (Other exchanges' controls over selling practices).

[13] In *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944), and *In re Duker & Duker*, 6 S.E.C. 386 (1939), it was held fraudulent for a broker-dealer to sell securities to its customers at unreasonable prices. Similarly, in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), "scalping" by an investment adviser—its having traded on the market impact of its own recommendations—was held to operate as a fraud or deceit upon its clients and prospective clients. And the defendant's conviction in *United States* v. *Naftalin, supra*, 441 U.S. 768, had nothing to do with

B. *Strong public policy considerations require the explicit rejection by this Court of the standard Judge Wright would apply to govern the conduct of brokers and dealers.*

Judge Wright has inferred from the securities laws taken as a whole an unqualified duty of broker-dealers to disclose-or-refrain whenever they are aware of material facts not generally known to the public and to report to the Commission the use of those facts by others. *See* 681 F.2d at 841-842. This principle would disable broker-dealers—who necessarily must, and constantly do, have access to non-inside information not generally known to the public—from performing many normal and beneficial market-facilitating functions. It would penalize analytical excellence, impair market efficiency and place in legal jeopardy those analysts who have sufficient insight to observe values not generally perceived or to recognize the existence of unsoundness or even fraud in securities before the common crowd. It would inhibit if not prevent confidential communications between issuers of securities and the broker-dealers who act as their investment bankers. And it would charge broker-dealers with law enforcement obligations that the Congress has specifically assigned to the Commission and the self-regulatory organizations.

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the fact that he was president of a broker-dealer; it was the result, instead, of fraud he had practiced as a customer of five other brokerage firms.

Even further removed from the facts of this case are *O'Neill* v. *Maytag*, 339 F.2d 764 (2d. Cir. 1964), and *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), upon which Judge Wright also relies. Both were shareholders' derivative actions against corporate insiders. Neither of those cases nor *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462 (1977)—raising an issue of corporate mismanagement—involved any question concerning the duties of brokers or dealers.

Judge Wright relies upon *O'Neill* v. *Maytag*, *supra*, 330 F.2d at 768-769, as suggesting "that Rule 10b-5, as applied to broker-dealers, might reach the sort of non-deceptive breach of fiduciary duty that does not come within the rule as applied to corporate managers." 681 F.2d at 840. But the language upon which he relies merely reserved that question and, in any event, the question reserved has been resolved to the contrary by this Court's opinion in *Santa Fe Indus., Inc.* v. *Green*, *supra*.

1. Judge Wright's principle would override the Congressional judgment and the rulemaking decisions of the Commission and would compel broker-dealers who perform essential market functions to forego informational advantages that have been found compatible with the public interest.

The Commission and the Congress have both noted on several occasions that the effectiveness of the securities markets is largely dependent upon the participation of securities dealers, such as "[s]pecialists, block positioners and floor traders, who . . . contribute to the public nature of securities markets by risking their capital to absorb imbalances in supply and demand."[14] The functions performed by these particular broker-

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[14] *See Adoption of Securities Exchange Act Rule 19b-2, Concerning the Utilization of Membership on National Securities Exchanges for Public Purposes,* Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902, 3918 (Feb. 8, 1973). *Accord, Securities Transactions by Members of National Securities Exchanges,* Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 Fed. Reg. 6084, 6088-6091 (1979); S. Rep. No. 94-75, *supra,* at 68, 99; H.R. Rep. No. 94-123, *supra,* at 57-72.

A "specialist" is a member of an exchange charged with the responsibility to maintain a fair and orderly market in those stocks assigned to it. Among other things, a specialist may be required to effect purchases and sales of securities on its own behalf in order to minimize temporary disparities between supply and demand. Specialists also receive and hold "limit orders"—that is, orders to buy or sell a stock if the market should reach a specified price. *See* 2 Special Study, *supra* n.12, at 47.

A "block positioner" is a broker-dealer in securities that facilitates the purchase and sale of large quantities of various securities, often by committing its own capital to buy a portion of the total number of securities involved. *See* Securities Exchange Act Release No. 15533, *supra,* 44 Fed. Reg. at 6088-6089. Although there is no consistently-applied definition of the term, a "block" of stock generally signifies at least 10,000 shares, or a quantity of stock with a current value of at least $200,000. *Id.,* 44 Fed. Reg. at 6089 n.45.

A "floor trader" is a member of an exchange that regularly effects transactions for its own account on the exchange floor. *See* 2 Special Study, *supra* n.12, at 47.

Other securities dealers include: over-the-counter market makers, who are responsible for maintaining a continuous marketplace for securities in the non-exchange market; odd-lot dealers, exchange members that specialize in facilitating transactions in units of less than 100 shares; *bona fide* arbitrageurs, who regularly effect proprietary trades seeking to obtain a profit from the disparity in prices available in two markets for a security and its equivalent; and risk arbitrageurs,

dealers are "necessary" in order to "increase the depth, liquidity and orderliness of trading markets, enabling investors to implement trading decisions with relative ease and confidence."[15]

Because of their central position in the markets, however, these broker-dealers must often engage in securities transactions while possessing valuable non-inside information not generally known to the public. This information relates, for example, to the (i) volume and type of order flow in a particular security; (ii) existing bids and offers on a specialist's "book";[16] (iii) inventory of a block positioner, particularly blocks of stock that are to be "liquidated" or "laid off"; (iv) positions of arbitrageurs and risk arbitrageurs; and (v) institutional interest in the purchase or sale of blocks of stock. In many situations this information is clearly material.

In view of the benefits they confer, the advantage that the market professionals gain in these circumstances is not viewed as hostile to the provisions or objectives of the Securities Exchange Act. The Commission has recognized that

> "market professionals have been permitted to enjoy these market information and competitive advantages because they have obligations to the markets for the securities that they trade and have made significant contributions to the

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who regularly effect proprietary trades in a security that is, or may be, the subject of a tender offer, or other corporate reorganization, with a view toward the eventual tender or sale of such a security. *See* Securities Exchange Act Release No. 15533, *supra*, 44 Fed. Reg. at 6089-6090.

[15] *See* Securities Exchange Act Release No. 9950, *supra*, 38 *Fed. Reg.* at 3918; *accord*, 8 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 64, 92d Cong., 1st Sess. at xxii (1971).

[16] A specialist's "book" is a book in which he enters, as a broker, limited price orders he has received from others to purchase or sell a specific security, at a specific price that is either higher or lower than the existing market in that security, for execution at a later time if the market moves to the price designated in such orders. The information in a specialist's book has an "importance beyond that of a mere repository of unexecuted agency orders. It serves as the indicator of public interest in a particular security." 2 Special Study, *supra* n.12, at 76.

> continuity, liquidity and depth of the markets for those securities."[17]

Thus, the Act vests in the Commission and in the self regulatory agencies broad authority, through appropriate regulation, to reconcile the possession and use by broker-dealers of valuable nonpublic trading information with the express statutory objective "to insure the maintenance of fair and honest [securities] markets . . . ."[18]

For example, as this Court recognized in *Chiarella, supra,* 445 U.S. at 233 n.16, Congress has expressly exempted specialists from the general statutory prohibition, set forth in Section 11(a)(1) of the Act, 15 U.S.C. §78k(a)(1), against members of a national securities exchange effecting transactions on the exchange for their own account. It specifically observed, 445 U.S. at 233 n.16, that

> "[t]he exception is based upon Congress' recognition that specialists contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of buy and sell orders."

And, based upon "[s]imilar concerns with the functioning of the market," Congress was recognized also to have exempted from the general prohibition against member trading "market

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[17] Securities and Exchange Commission, *Report of the Special Study of the Options Markets,* House Comm. on Int. and For. Commerce, Comm. Print No. IFC3, 96th Cong., 1st Sess. 1-4 (1978); *accord* 2 Special Study, *supra* n.12, at 76-83, 90, 127-128, 135, 203-242; *In re Albert Fried & Co.,* Securities Exchange Act Release No. 15293 (Nov. 3, 1978), 16 SEC Docket 100, 104 (Nov. 21, 1978) (The "*quid pro quo*" for conferring these advantages "has been the imposition of regulation to assure that in trading for his own account . . . [a dealer] uses those privileges for the benefit of the market generally . . . .").

[18] Section 2 of the Securities Exchange Act as originally passed, P.L. No. 291, §2, 73d Cong., 2d Sess. (1934).

makers, block positioners, registered odd-lot dealers, bona fide arbitrageurs and risk arbitrageurs . . . ." *Id.* [19]

2. Judge Wright's formulation would provide a substantial disincentive to security analysis—a separate and equally significant market function performed by employees of broker-dealers:

> "Exploration for relevant corporate and economic information is a service of value in the functioning of the market. If the information is related to the assets or expected performance of the enterprise, the sooner it is found, the more accurately it is appraised, and the more immediately it induces a purchase or sale, the more precisely will the market price of the securities correspond to the value of the enterprise."[20]

Thus, through careful research and evaluation of publicly available data, together with outside investigation which may include interviews with an issuer's representatives, the analyst will build a "mosaic" of information. [21]

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[19] *See* §11(a)(1), 15 U.S.C. §78k(a)(1); S. Rep. No. 94-75, 94th Cong., 1st Sess. 99 (1975). *See also* Securities Exchange Act Release No. 9950, 38 Fed. Reg. 3902, 3918 (1973). Similarly, Section 11(b) of the Act, as originally enacted, P.L. 291, §11(b), 73d Cong., 2d Sess. (1934), authorized the various stock exchanges to adopt rules which would permit "the registration of members as odd-lot dealers or specialists, or both," S. Rep. No. 1455, 73d Cong., 2d Sess. 100 (1934), and allow such trading "for their own account as may be reasonably necessary to permit them to maintain a fair and orderly market," *id.* at 30. Section 11(b) was amended in 1975 (P.L. No. 94-29, 94th Cong., 1st Sess. (1978)) "to provide . . . greater flexibility in prescribing a specialist's obligations in a national market system," S. Rep. No. 94-75, *supra*, at 100, by deletion of the original provision allowing members' trading for their own accounts only to the extent necessary for the maintenance of a fair and orderly market. Significantly, although the Act contemplates that specialists could and will trade for their own accounts, under Section 11(b) they are generally "forbidden to reveal information in respect to orders placed with them . . . ." S. Rep. No. 1455, *supra*, at 100.

[20] Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harvard L. Rev. 322, 341 (1979).

[21] SEC Opinion, *supra*, at 83,947. *See also* Solomon and Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 Fordham L. Rev. 505, 527-528 (1975).

As we noted above, page 4, the Commission, in its decision below, expressly recognized the important function served by securities analysts and the significant enhancement of market efficiency which results from effective analytical research and investigation. The Commission held, however, that a line must be drawn where an analyst comes into possession of material, non-public, "inside" information—in which case the analyst, like anyone else, is "constrained" by what the commission characterized as the "well-established proscriptions of the federal securities laws,"[22] requiring him either to publicly disclose the information or to refrain from trading or inducing trades by others. Thus, the Commission balanced the public interest in market efficiency, which results from vigorous investigatory analytical efforts, against the perception underlying the insider trading prohibition—that investor confidence in the marketplace will significantly be enhanced by forbidding the private use of inside information.

Judge Wright's decision ignores these factors and obliterates this distinction. Regardless of whether inside information is involved or the analyst has any nexus to the corporation or to its insiders, the principle he has articulated would compel any broker-dealer, whose employee has by analysis reached conclusions different from those generally prevalent in the public markets, to disclose that analyst's conclusions to the public or to refrain from trading or counselling others to trade. This is the context in which the analyst has the greatest value and for which he is most justly entitled to commendation and reward;[23] this is the situation in which his efforts and the resulting transactions will enhance market efficiency by helping to bring market prices in line with actual values.[24] Whatever

[22] SEC Opinion, *supra*, at 83,950.

[23] *See* Subcommittees of American Bar Association, Section of Corporation, Banking, and Business Law, Committee on Federal Regulation of Securities, *Comment Letter on Material Non-Public Information*, (Oct. 15, 1973), reprinted in 1 Sec. Reg. L. J. 328, 346 (1974).

[24] *See* 1 *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission*, House Comm. on Int. and For. Commerce, Committee Print No. 29, 95th Cong., 1st Sess. 63 (1977).

may have been the appreciation, intent or hope of the Commission in its disposition of this case (expressed in the SEC Opinion, *supra*, at 83,950), the duty formulated by Judge Wright will necessarily "hamper legitimate, investigative securities analysis," *id.*

3. As already noted, Judge Wright's transposition of ethical standards into what he perceives to be a legal duty on the part of broker-dealers to the public at large finds no support in the federal securities laws or their legislative history or in the judicial decisions. Indeed, Judge Wright has done what this Court specifically proscribed in *Chiarella, supra,* 445 U.S. at 231: he has created a "duty to everyone." Unless Judge Wright's views are expressly rejected, broker-dealer participants in the nation's capital markets, who deal professionally with instantaneous decisions against constantly changing prices based on a cluster of public and non-public non-inside information, would be paralyzed by a duty to cease market activities or to sift and make public disclosure, at their peril, of the material non-public portion of that information. Nowhere else in our society, insofar as we are aware, has so disabling a duty to the public at large been imposed on all members of an industry solely because of the business in which they are engaged. Neither Congress nor any court has ever seriously considered imposition of such a duty, much less adopted one.

But Judge Wright did not stop there. In addition to a duty to the public at large, he would also have these ethical standards give rise to a legal duty of broker-dealers promptly to report all material non-public information, both inside and non-inside information, to the Commission— in effect placing the hat and badge of a "policeman" on each individual member of a private, albeit heavily regulated, industry. One consequence, among many, would be the termination of broker-dealers' ability to act as "safe repositories of [investment banking] client confidences," *United States* v. *Newman, supra,* 664 F.2d at 17, on which rest the professional reputations of those broker-dealers who act as investment bankers. The underwriting of securities issues, the initiation and negotiation of

business combinations and divestitures, and the rendering of financial consulting services to business enterprises large and small, all depend on investment bankers being given access to confidential inside information, with accepted constraints on the use of such information. An obligation upon the investment banker to report that information to the Commission would destroy the clients' assurance of confidentiality and effectively preclude the informational interchange which is essential to the performance of investment banking functions.

No statute, Commission rule or judicial decision places such an onerous burden of affirmative police action on private persons in the securities industry or elsewhere. The Securities Exchange Act imposes regulatory and enforcement responsibilities on the self-regulatory organizations, not on their broker-dealer members. It is the Commission and the securities self-regulatory organizations, not broker-dealers, that have the legal obligation to investigate and determine the existence of securities law violations committed by others.[25] To impose a similar obligation on broker-dealers would make each broker-dealer the policeman of securities law compliance by all others with whom they come into professional contact—the companies whose securities they analyze or for whom they act as investment bankers as well as other broker-dealers. The mutual suspicion so engendered would place a rending strain on the fabric of the nation's capital markets.

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[25] Of course, a broker-dealer may be sanctioned if it has "failed reasonably to supervise" its own employees. *See* Securities Exchange Act §15(b)(4)(E), 15 U.S.C. §78*o*(b)(4)(E).

CONCLUSION

For the foregoing reasons, this Court should expressly reject the concept of a general duty owed by brokers and dealers to the public at large and to the Commission and the erroneous theory upon which it is based.

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